COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF THE UNION LIGHT, HEAT AND POWER COMPANY FOR DEVIATION FROM THE REQUIREMENTS OF KRS 278.2207(1)(b) TO PERMIT WINTER 2004 NATURAL GAS PURCHASES FROM CINERGY MARKETING & TRADING, LP, AN AFFILIATE	)))))))	CASE NO. 2004-00301

O R D E R

On July 30, 2004, The Union Light, Heat and Power Company ("ULH&P") applied, pursuant to KRS 278.2207(2), for a deviation from the requirements of KRS 278.2207(1)(b) to permit it to purchase natural gas from Cinergy Marketing & Trading, LP ("CM&T"), an affiliate, for the 2004-2005 heating season.

ULH&P is a Kentucky corporation engaged in the business of selling and distributing natural gas within the Commonwealth of Kentucky and is regulated by the Commission as a utility under KRS 278.010(3)(b). CM&T is an affiliate of ULH&P and is engaged in the business of marketing natural gas and electricity. The relationship between ULH&P and CM&T requires that the pricing for the proposed transaction comply with KRS 278.2207(1)(b), unless the Commission grants ULH&P a deviation.

The applicable sections of KRS 278.2207 provide:

> (1) The terms for transactions between a utility and its affiliates shall be in accordance with the following:
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> * * *
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> (b) Services and products provided to the utility by an affiliate shall be priced at the affiliate's fully distributed cost but in no event greater than market or in compliance with the

> utility's existing USDA, SEC, or FERC approved cost allocation methodology.
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> (2) A utility may file an application with the commission requesting a deviation from the requirements of this section for a particular transaction or class of transactions. The utility shall have the burden of demonstrating that the requested pricing is reasonable. The commission may grant the deviation if it determines the deviation is in the public interest.

ULH&P acknowledges that the proposed transaction does not comply with the requirements of KRS 278.2207(1)(b). It states that the proposed transaction is not priced at CM&T's fully distributed cost because natural gas is a commodity and that, as a marketer, CM&T sells natural gas at market price. It further states that the transaction is not priced in accordance with ULH&P's existing SEC and FERC approved cost allocation methodologies because the cost allocation methodologies do not apply to commodity transactions.

ULH&P states that, on May 14, 2004, it initiated a competitive bidding process to obtain a portion of its base load supply for the 2004-2005 winter season utilizing "cost averaging" pursuant to its approved hedging plan. It states that it received bids from three potential suppliers and that CM&T was the lowest bidder. ULH&P requests that the Commission approve a deviation from KRS 278.2207(1)(b) so that it can purchase this portion of its base load from CM&T.

ULH&P further states that, on June 11, 2004, it issued a request for proposal for the balance of its base load supply at the *Inside FERC First of Month Index* price and for 100 percent of its swing load supply at the *Gas Daily* midpoint price. ULH&P states that it received bids from 10 potential suppliers and that all the bids included a reservation fee. ULH&P wishes to enter into contracts with five of the suppliers and requests a deviation from KRS 278.2207(1)(b) to permit CM&T to be included as one of the suppliers for swing supply.

ULH&P asserts that the pricing of the proposed transaction with CM&T is reasonable and that it is in the public interest to grant the deviation requested. It argues that the cost of winter gas supply will increase if CM&T is excluded from ULH&P's supply portfolio.

The Commission, having considered the record, including the bid information submitted, and being otherwise sufficiently advised, finds that ULH&P has demonstrated that the proposed transaction with CM&T is reasonable and in the public interest.

ULH&P has previously sought similar deviations to the provisions of KRS 278.2207 concerning purchases of natural gas from CM&T. In those cases, as well as in this case, the Commission has issued data requests seeking information concerning ULH&P's bidding process and how the proposed transaction with CM&T is related to ULH&P's approved hedging plan. Given the prior history of these transactions, it is likely that ULH&P will enter into similar natural gas purchase transactions with CM&T or another affiliated company in the future. Therefore, we find that, if ULH&P seeks a deviation from the requirements of KRS 278.2207 in the future, it should include a detailed description of its bidding process and an explanation of the relationship between the purchase and its current hedging plan. The description should address any departures from ULH&P's normal bidding process and explain the reasons for the departures.

IT IS THEREFORE ORDERED that:

1. ULH&P's application to deviate from the provisions of KRS 278.2207(1)(b), as provided by KRS 278.2207(2), is granted.

2. This deviation applies only to the transaction described in this proceeding between ULH&P and CM&T for the winter of 2004-2005.

3. In any future application to deviate from KRS 278.2207, ULH&P shall include a detailed description of its bidding process, an explanation of the relationship between the purchase and its current hedging plan, and an explanation of and reasons for any departures from ULH&P's normal bidding process.

Done at Frankfort, Kentucky, this 1st day of October, 2004.

By the Commission

ATTEST:

Executive Director